National Bank of Ukraine

Strategy for easing of FX restrictions, transition to greater exchange rate flexibility and return to inflation targeting

National Bank of Ukraine

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Key takeaways

- **On June 29, 2023, the NBU approved Strategy for easing of FX restrictions, transition to greater exchange rate flexibility and return to inflation targeting** (hereinafter – the Strategy)
- The development of the Strategy is aimed at implementing the provisions of the Monetary Policy Guidelines for the period of martial law, as well as commitments under the Memorandum on Economic and Financial Policies with the IMF under the Extended Fund Facility Program (structural benchmark)
- **The purpose of the Strategy** is to set out **the priorities, principles and preconditions** to guide the implementation of monetary and exchange rate policy measures in an orderly and consistent manner. This approach will minimize risks to price and financial stability and maximize the potential for sustainable economic recovery
- **The NBU will follow the general approach in which:**
  - easing of the majority of FX restrictions imposed on trade transactions and those distorting the functioning of the FX market via multiple exchange rates will precede the increase in exchange rate flexibility
  - the refusal from the fixed exchange rate will precede the wide-scale liberalization of capital flows
  - a tight monetary stance will be maintained via appropriately high real interest rates, which will support sufficient attractiveness of hryvnia assets and thereby help minimize risks to exchange rate sustainability when easing FX restrictions and moving away from the fixed exchange rate regime
- **The Strategy is a framework document, its implementation will require specification of certain operational aspects taking into account:**
  - joint assessment with the IMF
  - its implications for other aspects of macroeconomic policy, and therefore - consistence with the objectives of the Extended Fund Facility Program

Over time, the costs of tight FX restrictions and fixed exchange rate start to outweigh their benefits …

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Following the outbreak of the full-scale war, a **fixed exchange rate regime** supported by tight FX restrictions **has played an important role in stabilizing inflation and exchange rate expectations and reducing inflationary pressures**

HOWEVER! In the longer term, it may become increasingly difficult to simultaneously achieve the objectives of price and financial stability, as well as sustainable economic growth

Over time, the costs could outweigh the benefits, in particular through:

- ↓ effectiveness of FX restrictions
- ↓ expectations around the credibility of the exchange rate peg
- stakeholders and market participants internalizing expectations of a fixed exchange rate

→ increased market distortions, shift of activity to shadow economy, diversion of resources to unproductive uses → **exacerbating external imbalances with spillovers to fiscal management**

→ gradual degradation of their business models and risk management systems → **accumulation of FX risks**

As a result: the economy is deprived of the opportunity to adapt to changes in external and internal conditions through exchange rate flexibility, while the central bank loses an important policy tool

…so the NBU should gradually return to a more flexible exchange rate and IT, when the right preconditions are in place

Stages	The first shock of the war	War of attrition	On the way to Victory	Peaceful time
	Monetary policy Guidelines for the period of martial law			**MP Guidelines after the Victory**
TASKS	▪ Prevent panic ▪ Ensure the smooth functioning of the banking and payment systems ▪ Ensure uninterrupted financing of Ukraine's defense needs and other critical budget expenditures	▪ Support the adaptation and stable functioning of the economy under martial law ▪ Minimize monetary financing of the state budget ▪ Manage inflation expectations	▪ Ensure persistent disinflation and ER sustainability ▪ Maintain a sufficient level of international reserves ▪ Facilitate creation of conditions for reintroduction of inflation targeting ▪ Avoid monetary financing of state budget	**Return to inflation targeting (as before the full-scale war)**
			(Phase I of the EFF program)	(Phase II of the EFF program)
MAIN ACTIONS	▪ Bank liquidity support, including anti-crisis tools ▪ Tight FX restrictions ▪ Fixed ER ▪ Budget support ▪ Restraining from key policy rate changes	▪ One-time correction of the official ER and maintaining a new level of the UAH/USD exchange rate ▪ Return to active interest rate policy ▪ Transition from lender of last resort to market maker of last resort (reducing the role of refinancing) ▪ Recalibration of MP operational design and strengthening monetary transmission ▪ Recalibration of FX restrictions	▪ Liquidity management, stimulation of competition among banks for term deposits, thereby strengthening monetary transmission and safeguarding macrofinancial stability **If conditions allow:** • Easing of FX restrictions and minimizing multi-currency practices • Gradual move to a more flexible ER • Normalization of MP operational design	**Strategy for easing FX restrictions, transition to greater ER flexibility and return to IT**

! **The NBU should, as conditions permit, return to inflation targeting with a floating exchange rate** as a regime that allows to ensure long-term achievement of the central bank's goals of price and financial stability simultaneously, as well as support sustainable economic growth

The Strategy was developed to fulfill the MP Guidelines and the commitments under the Memorandum with the IMF

Monetary Policy Guidelines for the Period of Martial Law

Provide for the return to inflation targeting regime with a floating exchange rate in the shortest possible time as the economy and financial system normalize

Memorandum on Economic and Financial Policies with the IMF under the Extended Fund Facility Program

Provide for the easing of administrative FX restrictions, transition to a more flexible exchange rate and return to inflation targeting as soon as conditions allow, as well as consistency with the Program's broader objectives of safeguarding price and external stability

The purpose of the Strategy is to set out the priorities, principles and preconditions to guide the implementation of monetary and exchange rate policy measures to return to inflation targeting with a floating exchange rate, and to ease currency restrictions, in an orderly and consistent manner that will minimize risks to price and financial stability and maximize the potential for sustainable economic recovery

The Strategy is a framework document, its implementation will require specification of certain technical and operational aspects…

The Strategy consists of **three main parts**, which generally describe the **key considerations** of the Strategy's implementation in the following areas

- **Easing of FX restrictions**
- **Moving to greater exchange rate flexibility**
- **Return to inflation targeting**

… this will ensure transition within the specified areas in an orderly and consistent manner

FX liberalization

- **Stage 1**
  ↓ multiple exchange rates; trade transactions; new loans and investments
- **Stage 2**
  Trade finance, currency risks of banks, interests on “old” debt
- **Stage 3**
  Payments on loans and investments; household transactions ; derivatives; investments abroad

Exchange rate flexibility

- Fixed exchange rate
- Gradual transition to greater exchange rate flexibility
- Floating with a volatility limit

Monetary regime

- Exchange rate sustainability
- Inflation targeting «lite»
- Inflation targeting

Macroeconomic and financial preconditions

Joint assessment with the IMF of the preconditions, possible impact and risks will guide the implementation of the Strategy

Principles	▪ The NBU will **carefully** and **consistently** implement measures within the key policy areas, including accounting for **the effects of incremental changes** in one policy area on other as well as the effectiveness of previous steps, which will be supported by careful analysis of the individual intended steps
Preconditions	▪ **Implementing any particular step of the Strategy will not be determined by time frames, but will follow a rigorous assessment of meeting a set of pre-established macroeconomic preconditions on a sufficiently durable basis** ▪ These criteria will ensure that adequate prerequisites are in place to support the successful implementation of steps under the Strategy, while safeguarding macroeconomic and financial stability amid a highly uncertain environment
Preparedness and risk assessment	▪ **Implementation of the Strategy requires a proper degree of technical and operational readiness for implementing changes** in monetary and exchange rate policy ▪ Given exceptionally high uncertainty associated with the war, progress under the Strategy will require **an assessment of the balance of risks in the near term**. Implementation of the Strategy's measures will take place when the probability of materialization of risks is assessed as acceptable, and/or it is possible to feasibly manage the impact of risk materialization ▪ **Intensification of risks may cause the suspension of the next steps or reversal of previous steps** to safeguard macroeconomic and financial stability
Joint assessment with the IMF	▪ **The implementation of the Strategy will require a holistic assessment of its implications for other aspects of macroeconomic policy, and should be consistent with the objectives of the Extended Fund Facility Program.** Thus, a joint assessment with IMF staff of the preconditions, likely impact on other policy areas, and risks will ensure that the Strategy is consistent with Program objectives

The assessment of the formation of appropriate preconditions will be based on evaluating developments of several key parameters

- Inflation and inflation expectations
- FX reserves level and FX market sustainability
- Interest rates (including positive real key policy rate and attractiveness of hryvnia instruments)
- Financial stability considerations

Easing of FX restrictions: *main stages*

The main criterion for prioritizing the easing of FX restrictions is the urgency to **correct distortions in the market** and **support the economic recovery, taking into account the relevant risks** to exchange rate sustainability and international reserves

I STAGE

Minimization of the practice of multiple exchange rates, liberalization of trade transactions and facilitation of new loans and investments

II STAGE

Liberalization of trade finance, management of FX risks of banks, the possibility of repatriation of interest on "old" debt obligations and investments

III STAGE

The possibility of payments on loans and investments, liberalization of households' transactions and transactions with derivatives, the possibility of lending to non-residents and investing abroad

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The sequence of steps within these stages is not fixed in advance. It may change if conditions arise such that a deviation from the envisaged sequence is determined to be more beneficial for the economy, the foreign exchange market and the financial system

Easing of FX restrictions: key principles

Easing of currency restrictions shall occur gradually and will be determined not by the timeframes, but by the formation of appropriate macroeconomic preconditions

Each step to ease currency restrictions shall be carried out on the basis of assessments of its impact on the foreign exchange market, international reserves, macroeconomic and financial stability, with the goal of minimizing the risk of reintroducing the relevant FX restriction. Easing of restrictions should not undermine the effectiveness of other restrictions that remain in force

Each subsequent step shall be preceded by an assessment of previous measures to ease FX restrictions

Introduction/easing/lifting of FX restrictions shall not be used to replace the necessary macroeconomic adjustment (in particular, using monetary or exchange rate policy instruments)

In the event of adverse circumstances, easing of currency restrictions may be suspended. FX restrictions may be reintroduced or even further tightened if necessary

Key principles of the evolution of the exchange rate regime

- **Exchange rate sustainability will remain an important element for achieving the goals of the NBU throughout the implementation of the Strategy**
- At the early stages, the NBU will continue to rely heavily on the exchange rate as a nominal anchor for the economy
- At subsequent stages, the NBU will allow for greater exchange rate flexibility, taking into account the consistency of policies to maintain confidence in the hryvnia and actions of the NBU to achieve inflation targets

Gradualism	**The increase in exchange rate flexibility will occur gradually.** At the early stages, it is important to maintain maximum possible exchange rate sustainability to minimize the initial shock to expectations in view of the NBU's exit from its commitment to peg the exchange rate
Consistency of policies to maintain credibility	▪ The NBU will maintain a sufficiently tight monetary policy stance that preserves the attractiveness of hryvnia assets in order to avoid uncontrolled increase in pressure on the FX market ▪ Besides that, the gradual easing of certain FX restrictions would support the preconditions for a transition to greater exchange rate flexibility. At the same time, maintaining other FX restrictions will continue to support exchange rate sustainability
Clear link to macroeconomic preconditions	The transition to greater exchange rate flexibility is happening not according to a pre-determined timeline, but based on the assessment of macroeconomic and financial conditions

Key characteristics of monetary policy regimes

Exchange rate sustainability	▪ The sustainable exchange rate is the main nominal anchor ▪ The NBU's key policy rate continues to serve as an auxiliary tool to ensure the sustainability of the exchange rate regime and protect international reserves ▪ The NBU takes measures to strengthen monetary transmission and ensure that hryvnia instruments are sufficiently attractive ▪ Under the baseline scenario, the normalization of the monetary policy operational design to be synchronized with the key policy rate cuts cycle, at the same time, the NBU is conscious of the need to maintain sufficient attractiveness of hryvnia assets
Inflation targeting «lite»	▪ The NBU's nominal anchor gradually shifts to inflation ▪ The key policy rate gradually restores its status as the main monetary instrument ▪ This is to be facilitated by the gradual restoration of the effectiveness of monetary transmission channels, as well as by the fact that the bulk of liquidity absorption transactions are conducted at the key policy rate ▪ A gradual curtailment of unconventional measures introduced since the beginning of the full-scale war is taking place
Inflation targeting	▪ Regime will be implemented using the principles and instruments defined in the NBU's Monetary Policy Strategy ▪ The key policy rate is the main instrument of monetary policy ▪ The NBU will return to a floating exchange rate regime, as before the full-scale war, as conditions permit ▪ The NBU adjusts its FX interventions mechanism, taking into account the objectives and principles enshrined in the Foreign Exchange Intervention Strategy of the National Bank of Ukraine ▪ The ban on monetary financing of the state budget by the NBU is restored

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The key policy rate will remain sufficiently positive in real terms during the period of return to inflation targeting, to help maintain the attractiveness of the hryvnia as a savings instrument, reduce demand for FX, and thus reduce pressure on the exchange rate and international reserves